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# NET INCOME PLUS DEPRECIATION, OPERATING CASH FLOW AND BUILDUPS IN OPERATING WORKING CAPITAL

## EXECUTIVE SUMMARY

While there are many advantages to a simple and readily available proxy for operating cash flow, there are inherent shortcomings as well. Such is the case with net income plus depreciation & amortization, a metric sometimes referred to as "cash earnings". In particular, net income plus depreciation & amortization does not take changes in operating working capital into account.

This report identifies several companies where in recent years, net income plus depreciation & amortization has been growing but where reported operating cash flow has been lagging. At these companies, operating working capital, including accounts receivable and especially, inventory, is not being realized and is increasing, in some cases, rapidly. The rapid growth in such accounts calls into question the sustainability of future earnings as the risk of write down and accompanying loss increases. While a write-down can be averted if accumulating operating working capital is ultimately realized, such was not the case at KB Home, or DR Horton, Inc., where write-downs of the companies' inventory of landholdings were recently announced.

January, 2007

**Georgia Tech Financial Analysis Lab**
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## Georgia Tech Financial Analysis Lab

The Georgia Tech Financial Analysis Lab conducts unbiased stock market research. Unbiased information is vital to effective investment decision-making. Accordingly, we think that independent research organizations, such as our own, have an important role to play in providing information to market participants.

Because our Lab is housed within a university, all of our research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Our focus is on issues that we believe will be of interest to a large segment of stock market participants. Depending on the issue, we may focus our attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in our work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. We define earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, our research may look into reporting practices that affect either earnings or cash flow, or both. At times, our research may look at stock prices generally, though from a fundamental and not technical point of view.

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**Companies Named in this Report**

# Net Income Plus Depreciation, Operating Cash Flow And Buildups in Operating Working Capital

## Important Findings

- In the homebuilding industry, the gap between net income plus depreciation & amortization is primarily due to a buildup in inventory.

  Consider the following three firms:

- DR Horton, Inc. – total gap of $6.3B for four years ended 2006.
- KB Home – total gap of $1.4B for three years ended 2005, with an additional increase of $1.1B year-to-date in 2006.
- Pulte Homes, Inc. – total gap of $4.2B for three years ended 2005, with an additional increase of $2B year-to-date in 2006.

- Outside the homebuilding industry, the gap between net income plus depreciation & amortization is due to increases in inventory and receivables.

  Consider the following firm:

- Revlon, Inc. (inventory and receivables) – total gap of $337M for three years ended 2005, with a decline in the gap of $37M year-to-date in 2006.

**Introduction**

It is useful to develop a proxy for operating cash flow that is easy to calculate and composed of information that is readily available. Such is the story behind the popularity of the idea of net income plus depreciation & amortization, referred to by some as "cash earnings". The thought process is to add depreciation and amortization (non-cash expenses) back to net income to get an easily calculated replacement for operating cash flow. As with many shortcuts, however, using net income plus depreciation & amortization as a replacement for operating cash flow has problems.

This research report examines why net income plus depreciation & amortization is not an appropriate proxy for operating cash flow. For a sample of companies, the report isolates differences between net income plus depreciation & amortization and operating cash flow (as calculated under generally accepted accounting principles or GAAP). In addition, the report identifies the implications of those differences for the sustainability of future earnings. In particular, growing differences between net income plus depreciation & amortization and operating cash flow highlight buildups in operating working capital. With such buildups in operating working capital the risk of special charges increases.

**Background**

An important shortcoming of net income plus depreciation & amortization is that it does not take into account changes in operating working capital - accounts like accounts receivable, inventory and prepaids, less accounts payable and accruals. For example, a company might be generating ample amounts of earnings and earnings before depreciation & amortization, but rather than actually collecting those earnings, they may be resulting in a buildup of non-cash operating working capital assets on the balance sheet. As that happens, the risk of impairment and a write-down of those assets and an accompanying loss increases.

Consider, for example, the recent charges taken by KB Home to write down the company's inventory of landholdings. As noted in a recent article in *The Wall Street Journal*,[1] the charges taken weren't surprising, ". . . considering the difficult market conditions." In other words, before the charge, the company's earnings and net income plus depreciation & amortization were not being fully realized. Growing inventory was the primary reason. As inventory increased and its realizability came into question, a write-down became necessary. As noted in this report, at KB Home, over the past three years, while earnings and net income plus depreciation & amortization were growing, operating cash flow was declining, and ultimately became negative. The growing gap between net income plus depreciation & amortization and operating cash flow, caused primarily by the increase in inventory, was a useful warning sign of the ensuing inventory write-down. A write-down was also announced recently at DR Horton, Inc. where a large gap between net income plus depreciation & amortization and operating cash flow had developed.

The calculation of operating cash flow begins by adding non-cash expenses like depreciation & amortization back to net income. However, period-to-period changes in operating working capital assets and liabilities must then be taken into account. As a result, net income plus depreciation & amortization and operating cash flow differ primarily by the changes noted in operating working capital.[2] If operating working capital does not change, net income plus depreciation & amortization and operating cash flow will be the same amount. Of course, these accounts do change, and accordingly, the reasons for differences between net income plus depreciation & amortization and operating cash flow are useful in isolating potentially problematic developments.

**Purpose**

The purpose of this research is to demonstrate that while net income plus depreciation & amortization is a valuable metric, it does not provide a clear picture of actual operating cash flow. The report also shows how differences between net income plus depreciation & amortization and operating cash flow can be used in assessing the sustainability of future earnings. That is, the more that earnings are backed by actual operating cash flow, the less the risk of a future charge to write down unrealized operating working capital assets.[3]

To construct our sample, we identified non-financial companies whose net income plus depreciation & amortization had risen by 20% or more over the past three years while, while at the same time, reported operating cash flow had declined by 20% or more. Using data from public filings, we calculated the gap between net income plus depreciation & amortization and reported operating cash flow. As a sidebar, we did not focus our sample selection process on any one industry. However, trends in earnings and cash flow tend to be consistent across industries. As a result, there was one industry that stood out in our study - the homebuilding industry. For this reason, and given the downturn that the homebuilding industry has experienced of late, we found KB Homes' inventory write-down, a charge that occurred while we were finishing our work, to be particularly noteworthy.

However, large differences between net income plus depreciation & amortization and operating cash flow are not limited to the homebuilders. Thus, our results also include firms from other industries that are experiencing buildups of operating working capital.

**Findings**

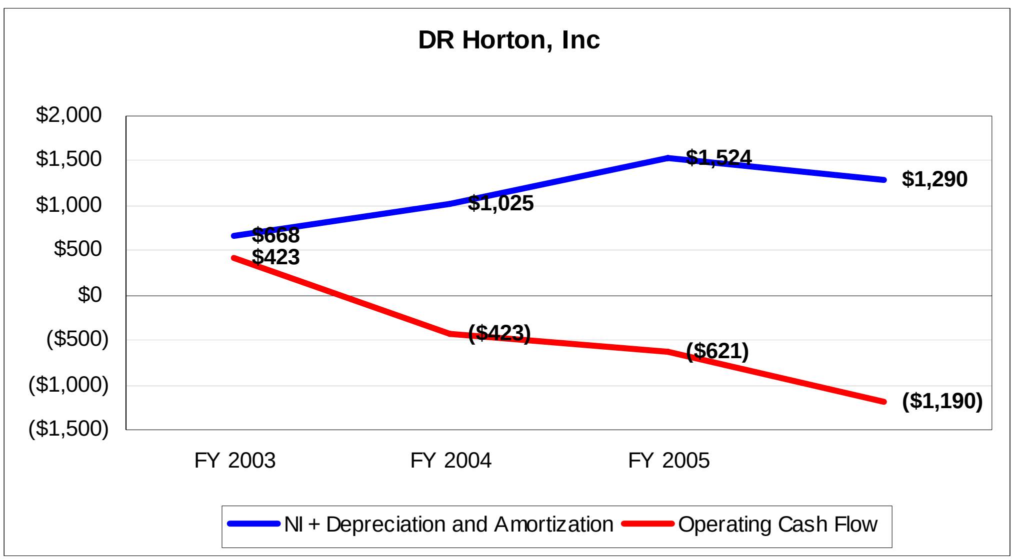
The results are presented in a series of tables and graphs. For each sample company, a table that reports net income (from continuing operations), the amount of depreciation & amortization, the sum of net income plus depreciation & amortization and the amount of reported operating cash flow for three years through fiscal year end 2005 is provided. A cumulative column reporting total results for the three years is included. Along with the results for the three annual periods, year-to-date results for 2006 are also reported. If the company has completed fiscal 2006, four years are shown as well as a four-year cumulative column. Each table contains the difference between net income plus depreciation & amortization and operating cash flow, referred to as the "gap". Finally, the primary reason for the gap is reported from the balance sheet.

We begin by highlighting four companies where the gap between net income plus depreciation & amortization and operating cash flow is particularly striking. Three of these firms are homebuilders, **DR Horton, Inc., KB Home and Pulte Homes, Inc.** The fourth firm is **Revlon, Inc.** We then turn our attention to other firms, including homebuilders and firms that are not in the homebuilding business, where differences between net income plus depreciation & amortization and operating cash flow are also quite sizable.

At **DR Horton, Inc.**, net income plus depreciation & amortization in 2006 was $1,290M, while reported operating cash flow was a use of cash of ($1,190M) for the same time period. As of year-end, September 2006, DR Horton reported over $11B in inventory on its balance sheet; up 33% from 2005 and up over 300% (from $2.8B) since 2001. Over the same period, operating cash flow has decreased from ($55.3M) in 2001 to ($1,190M) in 2006. The trend in operating cash flow presents a very different picture than that illustrated by the strong growth reported in net earnings plus depreciation and amortization.

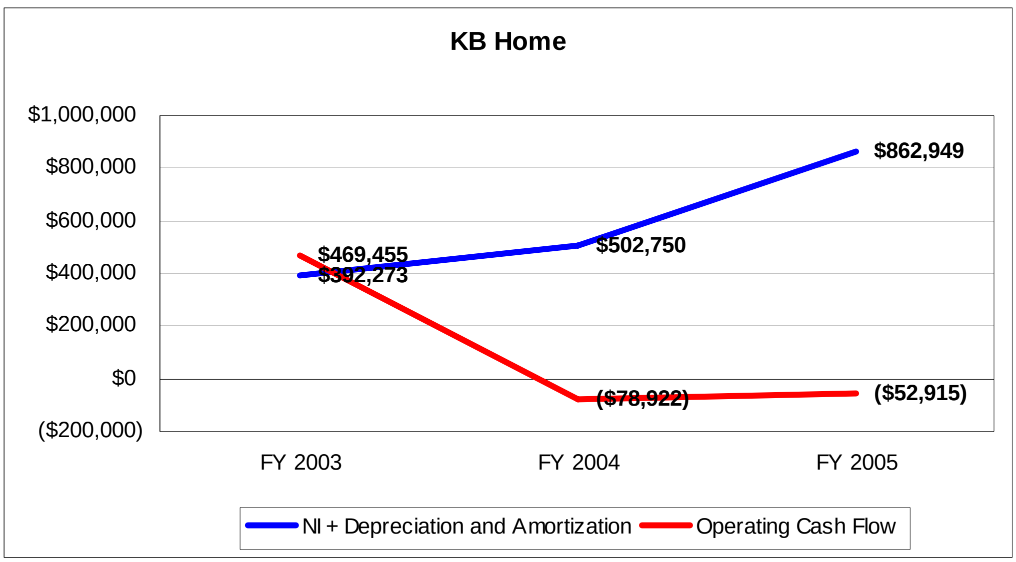
Note that these results include the effects of charges of $270.9 million for inventory impairments and land option cost write-offs.

| **DR Horton, Inc ($M)** | FY 2003 | FY 2004 | FY 2005 | FY 2006 | 4 Year Total |
|---|---|---|---|---|---|
| Net Income | $626 | $975 | $1,471 | $1,233 | $4,305 |
| Depreciation & Amortization | $42 | $50 | $53 | $57 | $202 |
| Net Income + Depreciation & Amortization | $668 | $1,025 | $1,524 | $1,290 | $4,507 |
| Reported Operating Cash Flow (OCF) | $423 | ($423) | ($621) | ($1,190) | ($1,811) |
| Gap between NI + Depreciation and Amortization and OCF | ($245) | ($1,448) | ($2,145) | ($2,480) | ($6,318) |
| Primary reason for gap: Residential land lots | | | | | |



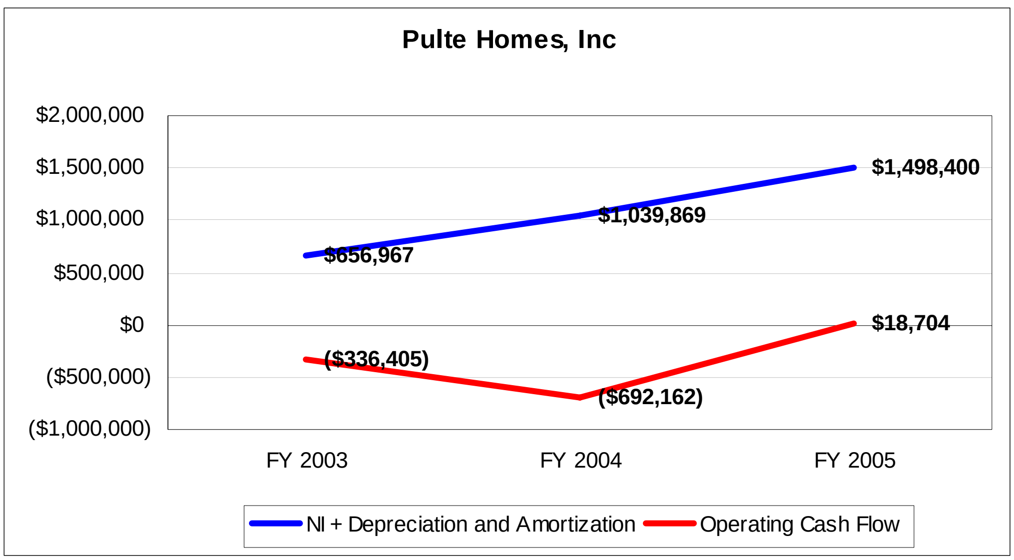
In the case of **KB Home**, net income plus depreciation & amortization was exceeded by operating cash flow in 2003, but by 2005, as net income plus depreciation & amortization increased to $863M, operating cash flow declined significantly and was a use of cash of ($53M). We examined KB Home's balance sheet and noted that the primary reason for the growing gap between net income plus depreciation & amortization and operating working capital was a significant increase in inventory. At KB Home**,** inventory increased from $1.88B in 2001 to $6.13B in 2005. By May 31, 2006, the latest financial statements available at the time of this writing, the balance in inventory stood at $7.57B.

| **KB Home ($T)** | FY 2003 | FY 2004 | FY 2005 | 3 Year Total | May '06 YTD |
|---|---|---|---|---|---|
| Net Income | $370,764 | $480,902 | $842,421 | $1,694,087 | $381,033 |
| Depreciation & Amortization | $21,509 | $21,848 | $20,528 | $63,885 | $9,832 |
| Net Income + Depreciation & Amortization | $392,273 | $502,750 | $862,949 | $1,757,972 | $390,865 |
| Reported Operating Cash Flow | $469,455 | ($78,922) | ($52,915) | $337,618 | ($684,515) |
| Gap between NI + Depreciation and Amortization and OCF | $77,182 | ($581,672) | ($915,864) | ($1,420,354) | ($1,075,380) |
| Primary reason for gap: Inventory | | | | | |



At **Pulte Homes, Inc**., the gap between net income plus depreciation & amortization and operating cash flow accumulated across the 2003 through 2005 timeframe reached $4.2B. During the nine months ended September, 2006, the gap increased by another $2B. The primary reason for the gap was house and land inventory. The account increased to $10.83B at September 30, 2006 from $8.76B and $7.24B at December 31, 2005 and 2004, respectively.

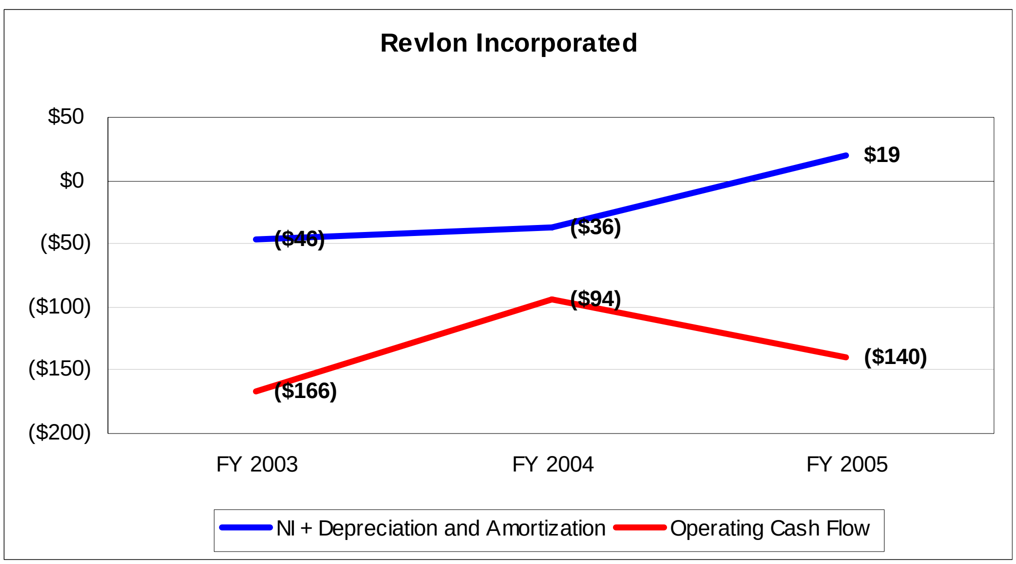
| **Pulte Homes, Inc ($T)** | FY 2003 | FY 2004 | FY 2005 | 3 Year Total | Sept '06 YTD |
|---|---|---|---|---|---|
| Net Income | $617,548 | $993,573 | $1,436,888 | $3,048,009 | $697,947 |
| Depreciation & Amortization | $39,419 | $46,296 | $61,512 | $147,227 | $58,509 |
| Net Income + Depreciation & Amortization | $656,967 | $1,039,869 | $1,498,400 | $3,195,236 | $756,456 |
| Reported Operating Cash Flow | ($336,405) | ($692,162) | $18,704 | ($1,009,863) | ($1,266,709) |
| Gap between NI + Depreciation and Amortization and OCF | ($993,372) | ($1,732,031) | ($1,479,696) | ($4,205,099) | ($2,023,165) |
| Primary reason for gap: Inventory | | | | | |



At **Revlon, Inc.**, the gap between net income plus depreciation & amortization and operating cash flow increased across the three years ended 2005. As net income plus depreciation & amortization became positive in 2005, increasing to $19M, the company continued to consume operating cash flow, reporting a use of cash of ($140M) during the same year. Between 2004 and 2005, receivables increased 41% to $282.2M from $200.6M and during the same period, inventories were up 43% to $220.6M from $154.7M. The gap did improve somewhat during the nine months ended September 30, 2006, as receivables declined to $166.9M and inventory declined to $206.9.

| **Revlon Inc. ($M)** | FY 2003 | FY 2004 | FY 2005 | 3 Year Total | Sept '06 YTD |
|---|---|---|---|---|---|
| Net Income | ($154) | ($143) | ($84) | ($380) | ($246) |
| Depreciation & Amortization | $108 | $106 | $103 | $317 | $84 |
| Net Income + Depreciation & Amortization | ($46) | ($36) | $19 | ($63) | ($162) |
| Reported Operating Cash Flow | ($166) | ($94) | ($140) | ($400) | ($125) |
| Gap between NI + Depreciation and Amortization and OCF | ($120) | ($58) | ($159) | ($337) | $37 |

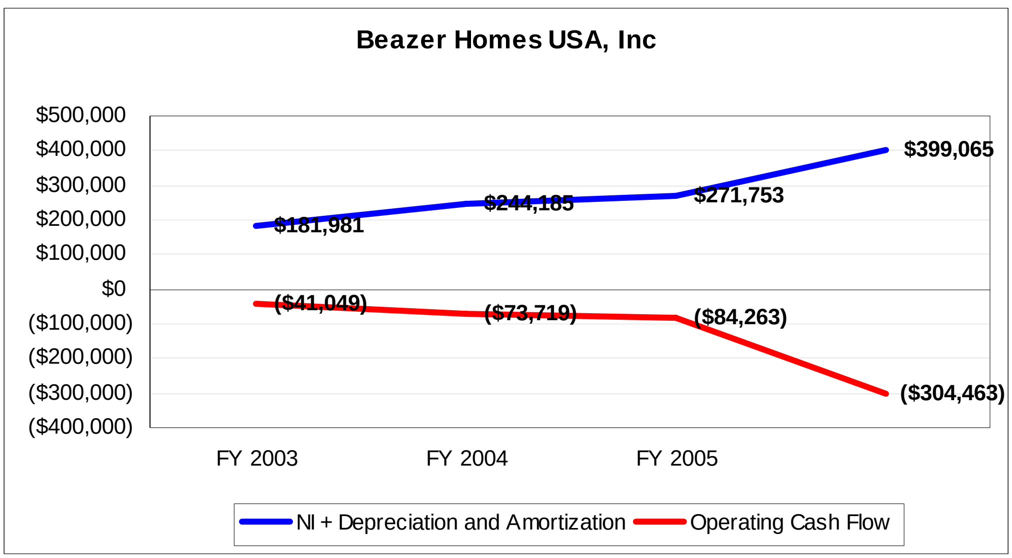
Primary reason for gap: Permanent displays, trade receivables, inventories



**Other Companies**
We found several other companies where significant differences between net income plus depreciation & amortization and operating cash flow were noted. Many of these were homebuilders, but several companies were from various other industries. The results are presented below. The homebuilders are presented first, followed by firms from other industries.

***Home Builders***

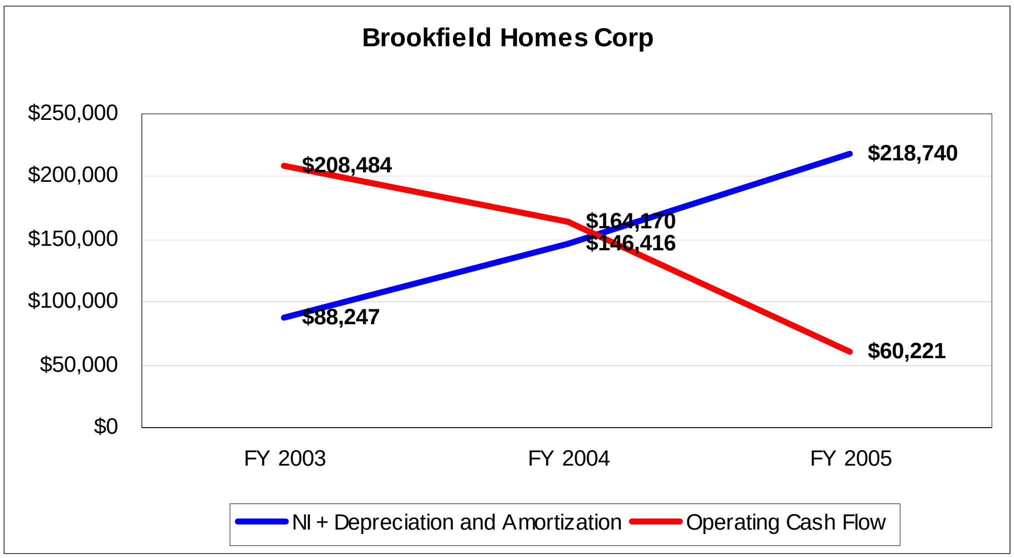
| **Beazer Homes USA, Inc ($T)** | FY 2003 | FY 2004 | FY 2005 | FY 2006 | 4 Year Total |
|---|---|---|---|---|---|
| Net Income | $172,745 | $235,811 | $262,524 | $388,761 | $1,059,841 |
| Depreciation & Amortization | $9,236 | $8,374 | $9,229 | $10,304 | $37,143 |
| Net Income + Depreciation & Amortization | $181,981 | $244,185 | $271,753 | $399,065 | $1,096,984 |
| Reported Operating Cash Flow (OCF) | ($41,049) | ($73,719) | ($84,263) | ($304,463) | ($503,494) |
| Gap between NI + Depreciation and Amortization and OCF | ($223,030) | ($317,904) | ($356,016) | ($703,528) | ($1,600,478) |
| Primary reason for gap: Inventory | | | | | |



## Brookfield Homes Corp.

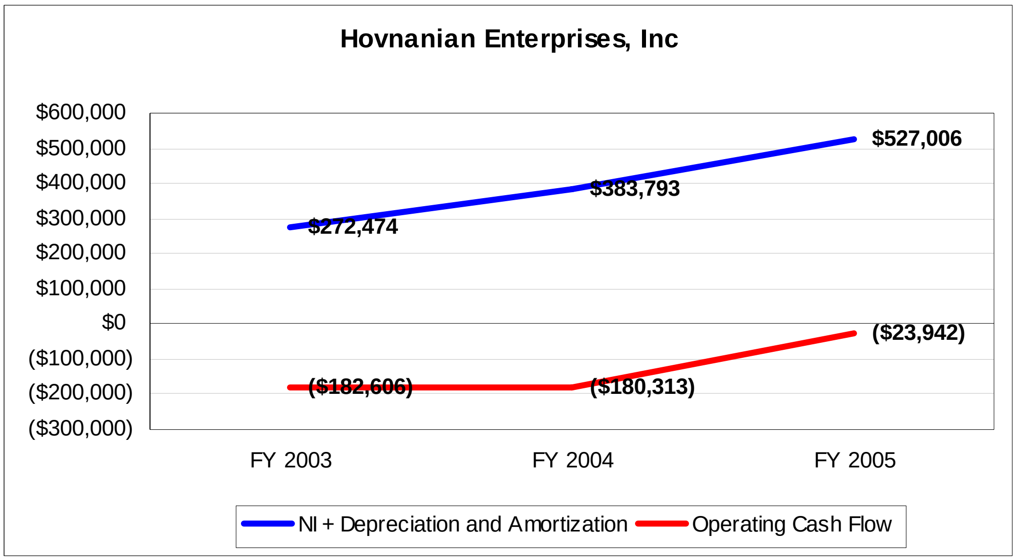
| **Brookfield Homes Corp ($T)** | FY 2003 | FY 2004 | FY 2005 | 3 Year Total | Sept '06 YTD |
|---|---|---|---|---|---|
| Net Income | $88,247 | $146,416 | $218,740 | $453,403 | $89,531 |
| Depreciation & Amortization (none disclosed on cash flow statement) | $0 | $0 | $0 | $0 | $0 |
| Net Income + Depreciation & Amortization | $88,247 | $146,416 | $218,740 | $453,403 | $89,531 |
| Reported Operating Cash Flow (OCF) | $208,484 | $164,170 | $60,221 | $432,875 | ($27,336) |
| Gap between NI + Depreciation and Amortization and OCF | $120,237 | $17,754 | ($158,519) | ($20,528) | ($116,867) |

Primary reason for gap: Housing and land inventory



## Hovnanian Enterprises, Inc.

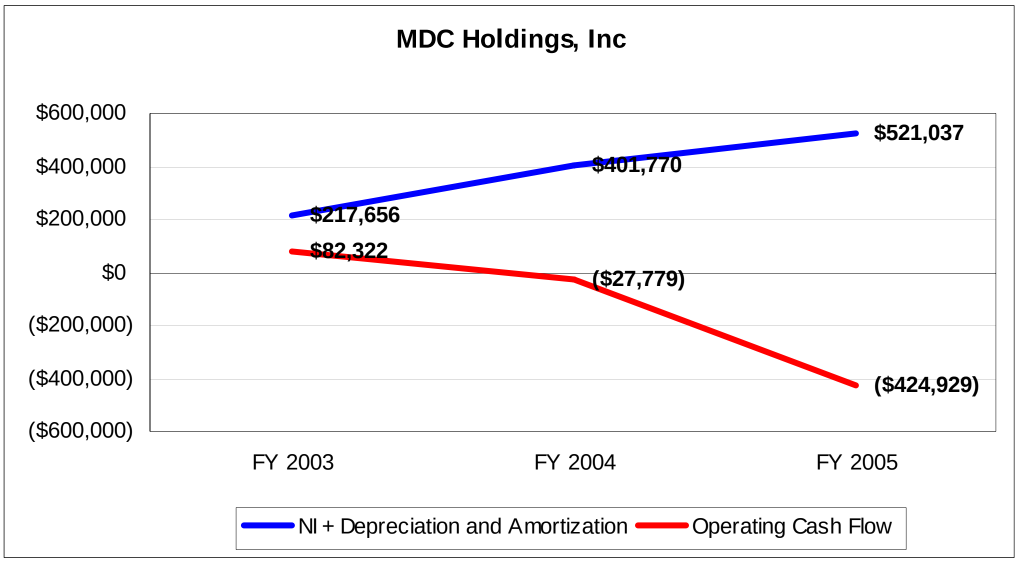
| **Hovnanian Enterprises, Inc ($T)** | FY 2003 | FY 2004 | FY 2005 | 3 Year Total | July '06 YTD |
|---|---|---|---|---|---|
| Net Income | $257,380 | $348,681 | $471,847 | $1,077,908 | $264,792 |
| Depreciation & Amortization | $15,094 | $35,112 | $55,159 | $105,365 | $48,978 |
| Net Income + Depreciation & Amortization | $272,474 | $383,793 | $527,006 | $1,183,273 | $313,770 |
| Reported Operating Cash Flow (OCF) | ($182,606) | ($180,313) | ($23,942) | ($386,861) | ($838,362) |
| Gap between NI + Depreciation and Amortization and OCF | ($455,080) | ($564,106) | ($550,948) | ($1,570,134) | ($1,152,132) |
| Primary reason for gap: Inventory | | | | | |



## MDC Holdings, Inc.

| **MDC Holdings, Inc ($T)** | FY 2003 | FY 2004 | FY 2005 | 3 Year Total | Sept '06 YTD |
|---|---|---|---|---|---|
| Net Income | $212,229 | $391,165 | $505,723 | $1,109,117 | $220,618 |
| Depreciation & Amortization | $5,427 | $10,605 | $15,314 | $31,346 | $41,537 |
| Net Income + Depreciation & Amortization | $217,656 | $401,770 | $521,037 | $1,140,463 | $262,155 |
| Reported Operating Cash Flow (OCF) | $82,322 | ($27,779) | ($424,929) | ($370,386) | ($41,343) |
| Gap between NI + Depreciation and Amortization and OCF | ($135,334) | ($429,549) | ($945,966) | ($1,510,849) | ($303,498) |

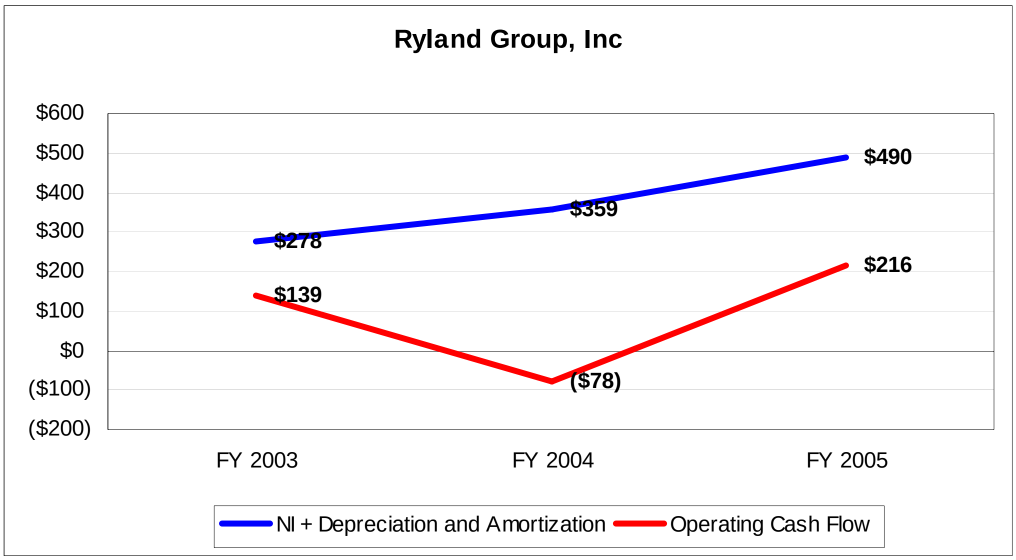
Primary reason for gap: Land and Completed Housing inventory



## Ryland Group, Inc.

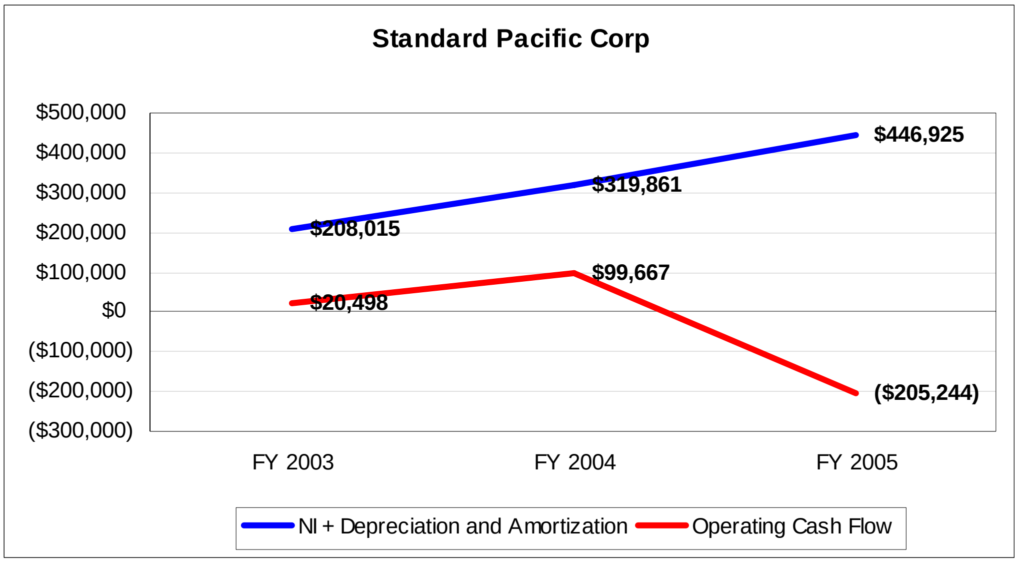
| **Ryland Group, Inc ($M)** | FY 2003 | FY 2004 | FY 2005 | 3 Year Total | Sept '06 YTD |
|---|---|---|---|---|---|
| Net Income | $242 | $320 | $447 | $1,009 | $273 |
| Depreciation & Amortization | $36 | $39 | $43 | $118 | $33 |
| Net Income + Depreciation & Amortization | $278 | $359 | $490 | $1,127 | $306 |
| Reported Operating Cash Flow (OCF) | $139 | ($78) | $216 | $277 | ($354) |
| Gap [3] | ($139) | ($437) | ($274) | ($850) | ($660) |

Primary reason for gap: Inventory



## Standard Pacific Corp.

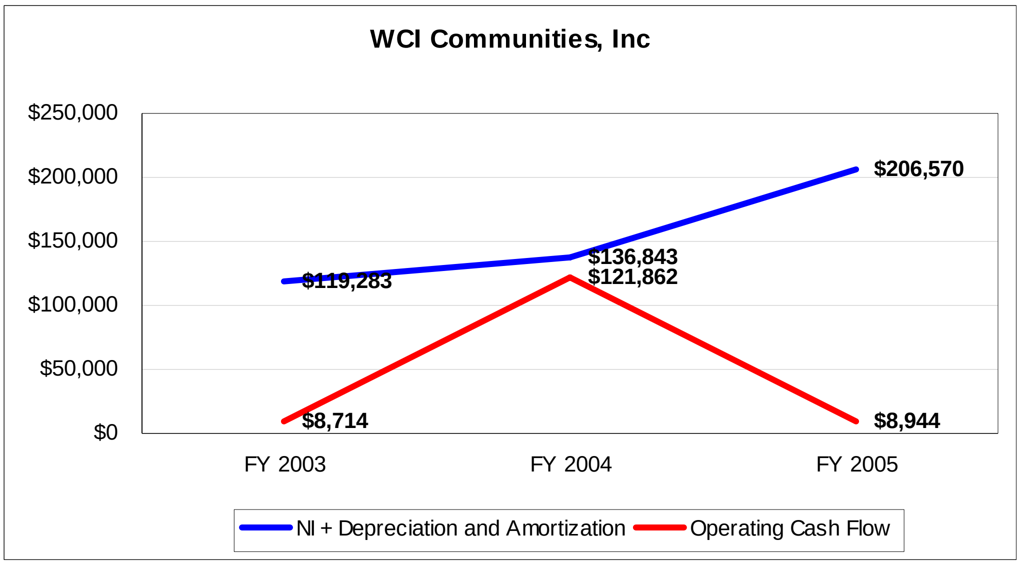
| **Standard Pacific Corp ($T)** | FY 2003 | FY 2004 | FY 2005 | 3 Year Total | Sept '06 YTD |
|---|---|---|---|---|---|
| Net Income | $204,379 | $315,817 | $440,984 | $961,180 | $222,099 |
| Depreciation & Amortization | $3,636 | $4,044 | $5,941 | $13,621 | $5,431 |
| Net Income + Depreciation & Amortization | $208,015 | $319,861 | $446,925 | $974,801 | $227,530 |
| Reported Operating Cash Flow (OCF) | $20,498 | $99,667 | ($205,244) | ($85,079) | ($506,787) |
| Gap between NI + Depreciation and Amortization and OCF | ($187,517) | ($220,194) | ($652,169) | ($1,059,880) | ($734,317) |
| Primary reason for gap: Inventory | | | | | |



**WCI Communities, Inc.**

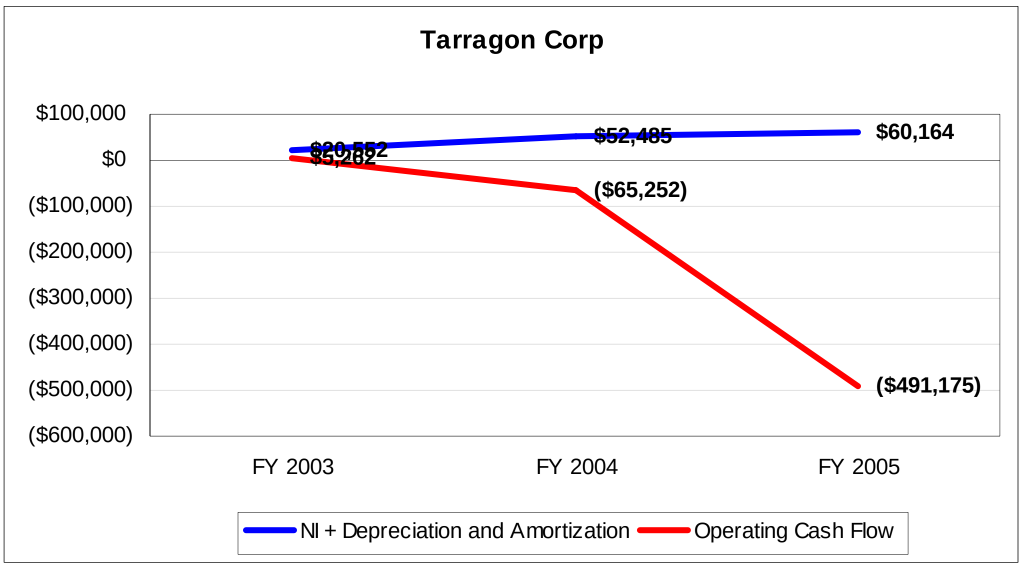
| **WCI Communities, Inc ($T)** | FY 2003 | FY 2004 | FY 2005 | 3 Year Total | Sept '06 YTD |
|---|---|---|---|---|---|
| Net Income | $105,560 | $120,203 | $186,150 | $411,913 | $73,576 |
| Depreciation & Amortization | $13,723 | $16,640 | $20,420 | $50,783 | $22,716 |
| Net Income + Depreciation & Amortization | $119,283 | $136,843 | $206,570 | $462,696 | $96,292 |
| Reported Operating Cash Flow (OCF) | $8,714 | $121,862 | $8,944 | $139,520 | ($604,994) |
| Gap between NI + Depreciation and Amortization and OCF | ($110,569) | ($14,981) | ($197,626) | ($323,176) | ($701,286) |

Primary reason for gap: Contracts Receivable



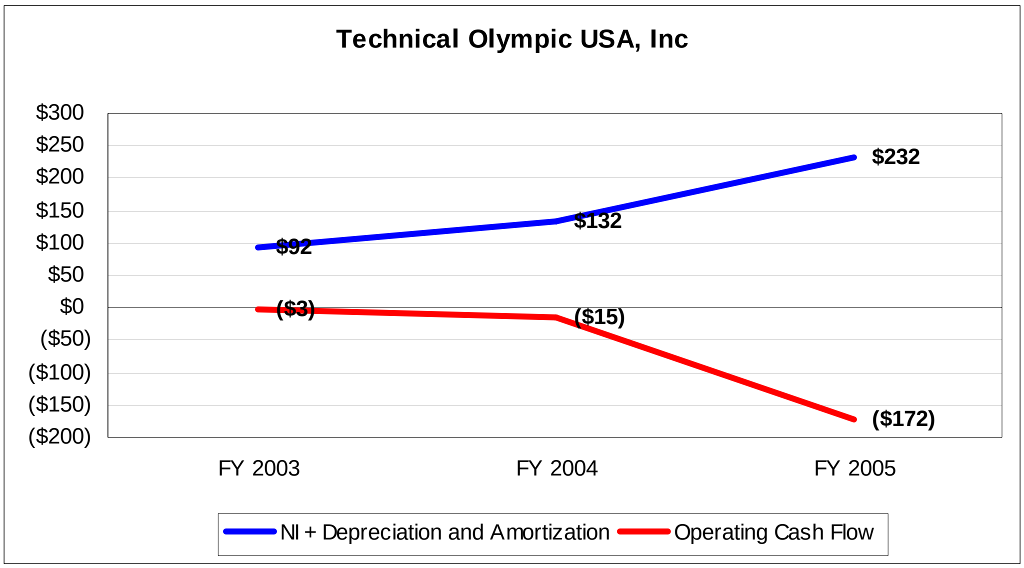
## Tarragon Corp.

| **Tarragon Corp ($T)** | FY 2003 | FY 2004 | FY 2005 | 3 Year Total | Sept '06 YTD |
|---|---|---|---|---|---|
| Net Income | $8,487 | $34,758 | $45,016 | $88,261 | $22,505 |
| Depreciation & Amortization | $12,065 | $17,727 | $15,148 | $44,940 | $12,625 |
| Net Income + Depreciation & Amortization | $20,552 | $52,485 | $60,164 | $133,201 | $35,130 |
| Reported Operating Cash Flow (OCF) | $5,262 | ($65,252) | ($491,175) | ($551,165) | ($244,953) |
| Gap between NI + Depreciation and Amortization and OCF | ($15,290) | ($117,737) | ($551,339) | ($684,366) | ($280,083) |
| Primary reason for gap: Inventory | | | | | |



## Technical Olympic USA, Inc.

| **Technical Olympic USA, Inc ($M)** | FY 2003 | FY 2004 | FY 2005 | 3 Year Total | Sept '06 YTD |
|---|---|---|---|---|---|
| Net Income | $83 | $120 | $218 | $421 | $43 |
| Depreciation & Amortization | $9 | $13 | $13 | $35 | $11 |
| Net Income + Depreciation & Amortization | $92 | $132 | $232 | $456 | $54 |
| Reported Operating Cash Flow (OCF) | ($3) | ($15) | ($172) | ($190) | ($179) |
| Gap between NI + Depreciation and Amortization and OCF | ($95) | ($147) | ($404) | ($646) | ($233) |
| Primary reason for gap: Inventory | | | | | |



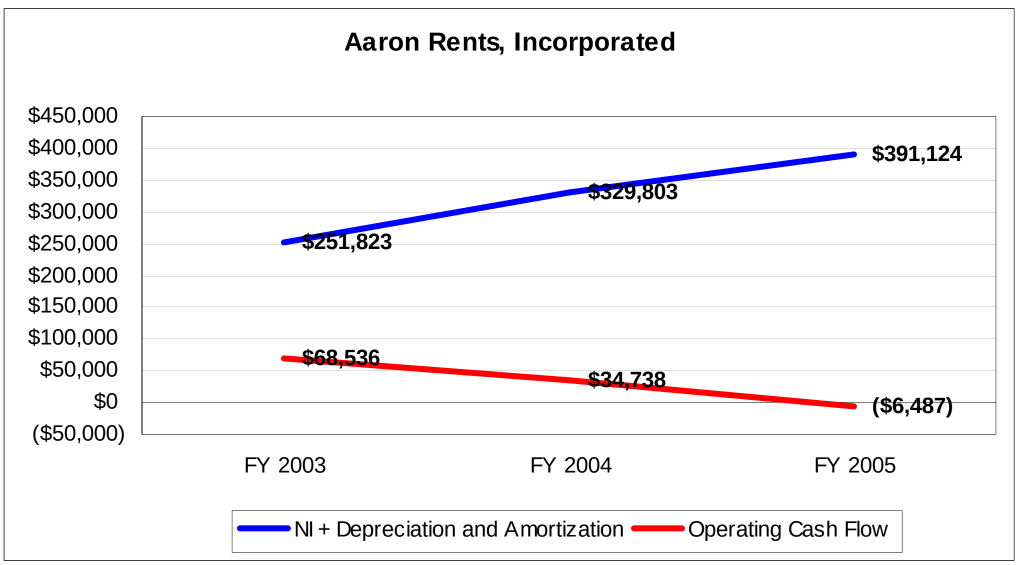
***Non Home Builders***

In addition to Revlon, Inc. discussed earlier, we look at four firms outside the homebuilding industry where the gap between net income plus depreciation & amortization and operating cash flow is large and growing. However, at these firms, Aaron Rents, Inc., Avnet, Inc., Central European Media Enterprises, Ltd., and Encore Wire Corp., we did not see increases in accounts receivable days and/or inventory days, indicating that the gap between net income plus depreciation & amortization and operating cash flow is growing at a rate that is commensurate with the growth in operations. As such, we see a reduced risk of a writedown. Still, the examples are instructive in demonstrating why net income plus depreciation & amortization, referred to by some as cash earnings, is not a good proxy for operating cash flow.

**Aaron Rents, Inc.**

| **Aaron Rents, Inc. ($T)** | FY 2003 | FY 2004 | FY 2005 | 3 Year Total | Sept '06 YTD |
|---|---|---|---|---|---|
| Net Income | $36,426 | $52,616 | $57,993 | $147,035 | $59,594 |
| Depreciation & Amortization | $215,397 | $277,187 | $333,131 | $825,715 | $296,762 |
| Net Income + Depreciation & Amortization | $251,823 | $329,803 | $391,124 | $972,750 | $356,356 |
| Reported Operating Cash Flow (OCF) | $68,536 | $34,738 | ($6,487) | $96,787 | $98,279 |
| Gap between NI + Depreciation and Amortization and OCF | ($183,287) | ($295,065) | ($397,611) | ($875,963) | ($258,077) |

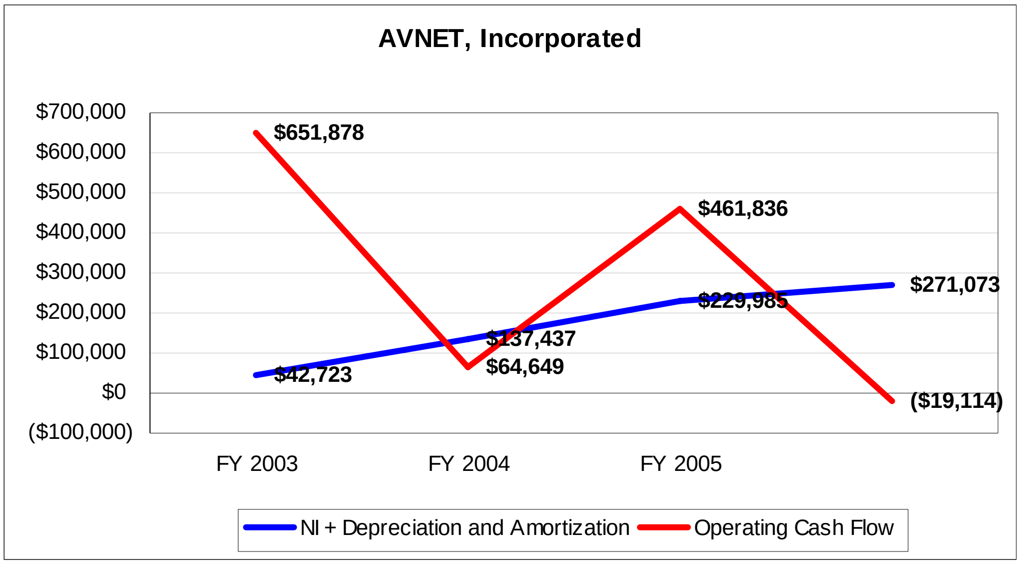
Primary reason for gap: Additions to rental merchandise.



## AVNET, Inc.

| **AVNET, Inc. ($T)** | FY 2003 | FY 2004 | FY 2005 | FY 2006 | 4 Year Total |
|---|---|---|---|---|---|
| Net Income | ($46,116) | $72,897 | $168,239 | $204,547 | $399,567 |
| Depreciation & Amortization | $88,839 | $64,540 | $61,746 | $66,526 | $281,651 |
| Net Income + Depreciation & Amortization | $42,723 | $137,437 | $229,985 | $271,073 | $681,218 |
| Reported Operating Cash Flow (OCF) | $651,878 | $64,649 | $461,836 | ($19,114) | $1,159,249 |
| Gap between NI + Depreciation and Amortization and OCF | $609,155 | ($72,788) | $231,851 | ($290,187) | $478,031 |

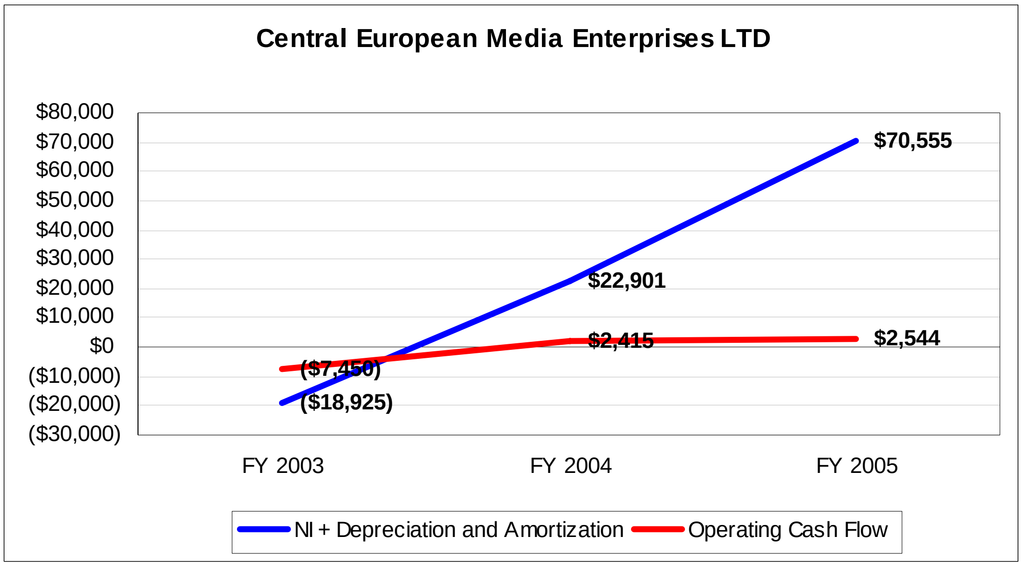
Primary reason for gap: Receivables



## Central European Media Enterprises LTD

| **Central European Media Enterprises LTD ($T)** | FY 2003 | FY 2004 | FY 2005 | 3 Year Total | Sept '06 YTD |
|---|---|---|---|---|---|
| Net Income | ($24,201) | $16,007 | $43,008 | $34,814 | $67,907 |
| Depreciation & Amortization | $5,276 | $6,894 | $27,547 | $39,717 | $111,443 |
| Net Income + Depreciation & Amortization | ($18,925) | $22,901 | $70,555 | $74,531 | $179,350 |
| Reported Operating Cash Flow (OCF) | ($7,450) | $2,415 | $2,544 | ($2,491) | $67,907 |
| Gap between NI + Depreciation and Amortization and OCF | $11,475 | ($20,486) | ($68,011) | ($77,022) | ($111,443) |

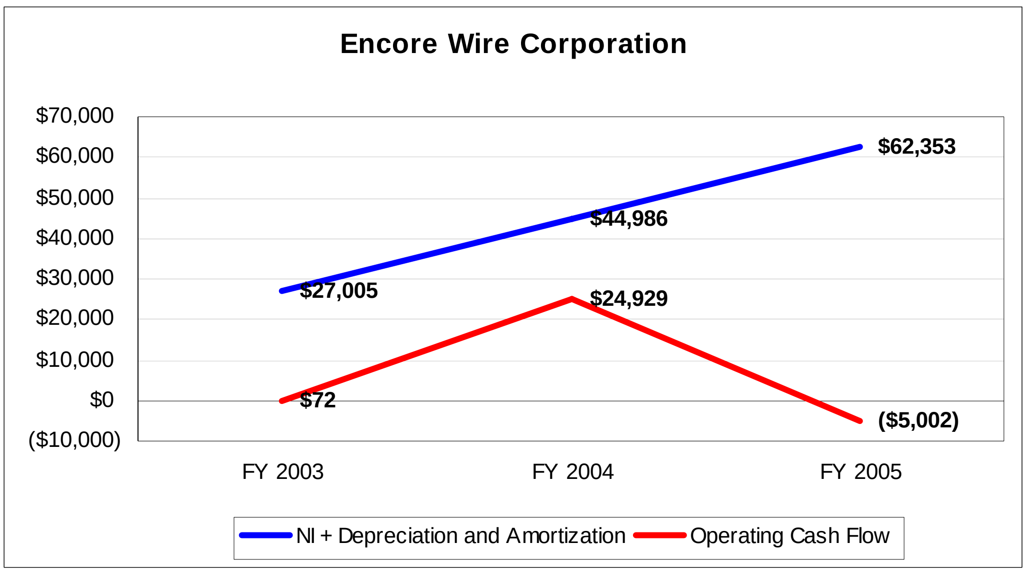
Primary reason for gap: Programming rights



**Encore Wire Corp.**

| **Encore Wire Corporation ($T)** | FY 2003 | FY 2004 | FY 2005 | 3 Year Total | Sept '06 YTD |
|---|---|---|---|---|---|
| Net Income | $14,375 | $33,360 | $50,078 | $97,813 | $108,957 |
| Depreciation & Amortization | $12,630 | $11,626 | $12,275 | $36,531 | $9,052 |
| Net Income + Depreciation & Amortization | $27,005 | $44,986 | $62,353 | $134,344 | $118,009 |
| Reported Operating Cash Flow (OCF) | $72 | $24,929 | ($5,002) | $19,999 | ($63,852) |
| Gap between NI + Depreciation and Amortization and OCF | ($26,933) | ($20,057) | ($67,355) | ($114,345) | ($181,861) |
| Primary reason for gap: Increase in accounts receivable* | | | | | |

*According to the company, the increase in accounts receivable is due to the increase in the price of copper over the past three years. Refer to "Reasons to Expect Homebuilder Writedowns," by Michael Rapoport, *Dow Jones Newswires*, January 18, 2007. We did not note an increase in accounts receivable days.



**Conclusion**
Net income plus depreciation and amortization is quick and calculated from readily available information, and useful in its own right. However, it falls short as a proxy for operating cash flow. Changes in accounts receivable, inventory, and prepaids all need to be considered when measuring the sustainability of a companies operating cash flow.

Buildups in operating working capital accounts can lead to a write-down if accounts such as inventory and accounts receivable are being held at an unrealizable value on the balance sheet. Conversely, the more earnings are backed by operating cash flow, the less likely a charge of this type. By comparing net income plus depreciation & amortization with operating cash flow, one can identify companies that are more at risk for a write-down. A relevant example is the inventory charge recently announced by KB Home.

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[1] *KB Home Warns of Charges;* http://online.wsj.com/article/SB116563129308945342.html
[2] Investing-related gains and losses are also removed from net income in calculating operating cash flow.
[3] Of course, operating cash flow calculated in accordance with generally accepted accounting principles can have its own problems, as documented in Mulford and Comiskey, *Creative Cash Flow Reporting: Uncovering Sustainable Financial Performance* (Wiley, 2006). However, GAAP-defined operating cash flow is still a useful metric in isolating buildups in operating working capital.